

MEMORANDUM

July 12, 2011

To: City Council Finance Committee

From: Lauren Bradley, Finance and Management Services Director

Via: Gary W. Jackson, City Manager

Subject: Fiscal Year 2010-2011 Audit Report

Introduction: Based on recent City council direction, the Finance Committee will receive monthly updates as part of the FY 2010-2011 audit process. These updates are intended to enhance City Council's involvement with financial reporting and the overall audit process, ensuring that both topics are adequately addressed by the governing body, while providing a practical vehicle for regular and direct communication between the independent auditors and City Council. The purpose of this first report is to provide basic information about the audit, an overview of the audit process and schedule, and a status report on work completed to date from the independent auditors, Dixon Hughes.

Background & Overview

What is a financial statement audit?

The goal of the annual financial statement audit is to assure users that those statements are "fairly presented." In most cases, the fairness of the presentation of a set of financial statements is determined using a set of criteria known as "generally accepted accounting principles" (GAAP). The most important source of GAAP for state and local governments is the Governmental Accounting Standards Board (GASB). GAAP provide consistency in financial reporting. In other words, they offer rules and formats for all governments in the country to follow in preparing financial statements for external use. Thus the GAAP financial statements of a government in California may be compared with those of a government in North Carolina. The consistency is invaluable to those outside the government who rely on this information - primarily investors, creditors, and bond rating agents, as well as to federal and state agency personnel.

What degree of assurance do auditors seek to provide?

The goal of the auditor is to obtain reasonable, not absolute, assurance that the financial statements are fairly presented. Accordingly, auditors typically do not attempt to examine individually every transaction or event affecting a government's financial statements. Rather, auditors perform their work on a "test basis," much as those conducting opinion surveys interview only a random sample of people. Similarly, the concept of reasonable assurance means that auditors do not attempt to ensure that all of the data contained in the financial statements are 100 percent accurate, but rather that the financial statements are free from any "material" misstatements. A potential error is considered to be "material" to the financial statements if it could have the effect of changing a reader's impression of the government's financial position, results of operations, or cash flows.

What does GAAP require?

GAAP require that state and local governmental entities use fund accounting, a concept unique to the government environment. Unlike agencies in the private sector, governmental entities provide a tremendous variety of services. Some services are “public purpose” in nature (for example, public safety, public works). Others are “business-like” (for example, public utilities like water service). The public-purpose services are primarily financed by taxation (property taxes, sales taxes, and so forth), whereas most business-like services are primarily financed by user fees (that is, payments by those using the services). In most cases, the various revenue sources for the services each have restrictions on how they may be used. Fund accounting is an accounting and reporting vehicle that allows segregation of these services and their revenue sources. Fund accounting uses three basic categories of funds: governmental, proprietary, and fiduciary. Within each category, several fund types are available to account for all the government’s activities and services.

To present the minimum information required by GAAP, governmental entities must prepare up to six basic financial statements and a comprehensive set of related “note disclosures” (footnotes that communicate essential information not disclosed in the body of the financial statements themselves). North Carolina statutes require that all local governmental entities prepare these GAAP financial statements for the end of each fiscal year and have them audited by an independent certified public accountant. These basic financial statements present aggregated information for each fund type.

How does the audit process work?

The audit process is divided into five (5) distinct phases as follows:

1. Interim compliance and internal control testing (May and June)
2. Close-out of the fiscal year and preparation of financial work papers (July and August)
3. Validation and verification of year-end balances (September)
4. Preparation of financial statements, notes, transmittal letter, management discussion and analysis (October)
5. Delivery to City Council and Local Government Commission (November)

To date, Dixon Hughes and City staff have completed phase 1. During that phase, the City provided bank statements, internal control narratives of major financial sub-systems (such as payroll, human resources, fixed assets, accounts receivable) and a preliminary schedule of federal and State financial assistance. Dixon Hughes selected transactions for testing and conformance to the stated processing standards, reviewed compliance with federal and State rules and regulations and reviewed bank statements. Additionally, Dixon Hughes reviewed the financial general ledger to obtain an understanding of how current the City was with posting financial transactions and reconciling the major sub-systems such as bank statements, fixed assets, payroll, debt, etc.

During phase 1, Dixon Hughes was on site for approximately two weeks. From Staff’s perspective, significant and major progress was achieved, when compared to the previous year’s effort. Brian Broom from Dixon Hughes will share his perspective at the Finance Committee meeting.

During phase 2 (July and August), City staff will be preparing the numerous financial work papers and continuing to review July and August transactions that are accrued and posted to the audit year. Generally, Dixon and Hughes will not be on-site during this period as the City closes the audit year and prepares the work papers.

During phase 3 (September), Dixon Hughes will return to the City and begin reviewing the work papers that support the year-end audit financial balances. During this phase of review, Dixon Hughes gains comfort with the year-end balances provided by the City.

During phases 4 and 5 (October and November), Dixon Hughes and City staff redirect their efforts to the preparation and presentation of the CAFR.

Next Steps

At the July 12, 2011 Finance Committee meeting, Brian Broom, representing Dixon Hughes, will provide a status report on the City's progress with the annual audit to date.

At the August Finance Committee meeting, Staff will update the Committee on phase 2 year-end closing activities. Dixon Hughes will return to the September and October Finance Committee meetings to provide updates on progress with phases 3-4. The audit is scheduled for presentation to the City Council on November 22, 2011.

CC: All Department Directors
All Finance Division Heads